20.01 Overview of Governmental Accounting

The principles of accounting by a governmental unit are different from those of a private business. A private business prepares financial statements (F/S) for use by creditors and investors in making lending and investing decisions. A government's F/S are used to provide accountability for the use of resources and to make **social and political decisions**. As a result, a unique system of financial reporting has been developed, known as **modified accrual** accounting, and is used to account for most of the activities of a typical governmental entity.

Private Business (FASB)	Government (GASB)
Revenues – Voluntary • Earned & • Realizable • **Accrual accounting** – uses the Economic resources measurement focus (all resources available)	**Revenues – Involuntary** • Measurable • Available • **Modified accrual** – uses the Financial resources measurement focus (current resources) Recognize when **Received:** income taxes, business licenses, tolls **Accrue for:** • Property taxes (60 days) • Grants 　○ unrestricted – approved 　○ restricted – spent
Costs • Selfish / (spend $ to make $) • Expenses, matching, depreciation expense	**Costs** • Unselfish • Expenditures, no matching
Profit motivated Revenue, expenses and Retained Earnings (Net Position)	**Budget compliance** Revenue, expenditures, and changes in Fund Balance

Principles

One of the principles that is central to modified accrual accounting is the **interperiod equity concept**. In general, government activity is approved and then carried out on an annual basis.

- At the beginning of the year, the legislative body of the government approves a budget.
- The employees attempt to carry out the directives given to them over the course of that year.

- At the end of the period, the F/S are utilized to evaluate the success of the departments in meeting their directives for that period.

The interperiod equity concept keeps the focus on a single period, with the revenues of the period intended to cover the spending of that period. This is, of course, consistent with the idea of trying to maintain a **balanced budget** so that costs in the current period aren't paid by future taxpayers. At the same time, this focus on evaluating government activity one period at a time means that future periods are essentially ignored.

In modified accrual accounting, a department will usually not account for long-term assets and long-term debt since these represent those future periods. The purchase of an asset is simply treated as a current outflow of financial resources and the proceeds from a long-term borrowing a current inflow. No depreciation is recorded on assets, and interest and principal owed on long-term debt are not recorded until the periods in which they must be paid.

Modified accrual accounting is easiest to understand if the interperiod equity concept focus on one period at a time is kept in mind. In measuring the transactions under **modified accrual accounting**, the following **measurement principles** are used:

- **Revenues** – These are recognized in the period they are **available to spend**, which means collectible in the current period to pay liabilities, or within 60 days after year end. Revenues billed or collected in advance are deferred until the appropriate future period. Revenues that are not measurable are treated as available to spend once they are collected.
- **Costs** – These are recognized using the expenditure principle. Costs are recorded in the period that the obligation to pay them arises, whether this is before or after the period in which the government is actually using the assets or services. Costs are generally recorded when the related fund liability is incurred, except as it relates to unmatured interest on L/T debt, as this is only recorded when it becomes legally due.
- **Reporting** – The F/S that are prepared include a balance sheet to present the financial position and a statement of revenues, expenditures, and changes in fund balance to present the flow of financial resources during the year. There is no equivalent in modified accrual reporting to a statement of cash flows.
- **Accountability** – Budgets are typically developed at the beginning of each year, and the focus of governmental financial reporting is on determination of compliance with budgets and accountability for resources. Any fund utilizing annual budgets must prepare a reconciliation of budget to actual amounts to be presented as supplementary information in the F/S. Elected officials are accountable to their constituents.

GAAP Hierarchy for State and Local Governments

Accounting principles for state and local governments are established by the Governmental Accounting Standards Board (GASB). The codification includes a hierarchy that identifies what constitutes authoritative GAAP for all state and local government entities and the priorities with which they should be applied: that is, Category A first, then Category B. Once the authoritative sources have been exhausted, then appropriate nonauthoritative sources may be considered.

Governmental GAAP Hierarchy	
Category A	• GASB Statements • GASB Interpretations
Category B	• GASB Technical Bulletins • GASB Implementation Guides • AICPA literature that has been cleared by the GASB
Nonauthoritative Sources	• GASB Concepts Statements • Pronouncements and other literature of the FASB, Federal Accounting Standards Advisory Board (FASAB), International Public Sector Accounting Standards Board (IPSASB), and International Accounting Standards Board (IASB) • AICPA literature not cleared by GASB • Practices that are widely recognized and prevalent in state and local government • Literature of other professional associations or regulatory agencies • Accounting textbooks, handbooks, and articles

Annual Budgets

When annual budgets are utilized in the accounting for a government department, *expected sources and uses* may include:

- **Estimated revenues** – Revenues that are expected to be available to spend in the period.
- **Estimated other financing sources** – Expected proceeds from issuance of long-term debt and operating transfers from other government departments.
- **Appropriations** – Expenditures that are expected to occur in the period.
- **Estimated other financing uses** – Expected operating transfers to other government departments.

Budgetary entries are made at the beginning of the year and closed out (reversed) at the end of the year. These estimated accounts are used to control expenditures, account for taxes that are being levied, estimate transfers in and out, and for planning purposes. If a balanced budget has been prepared, the sum of the estimated revenues and estimated other financial sources will equal the sum of the appropriations and estimated other financial uses.

If a budgetary surplus or deficit is expected, it will be reported as an increase or decrease in the equity. The equity section of a government department using modified accrual accounting consists of **fund balances**, and the budgetary account used is **budgetary fund balance – unreserved.** It is identified as unreserved because it represents anticipated activity, but no actual legal commitments.

For example, if the legislative budget for a department using modified accrual accounting includes expected revenues of $700, bond proceeds of $200, expenditures of $500, and operating transfers to assist other departments of $250, the journal entry made at the **beginning of the fiscal year** is:

Estimated revenues	700	
Estimated other financial sources	200	
Budgetary fund balance – unreserved		150
Appropriations		500
Estimated other financial uses		250

Revenues

When using the **modified accrual approach**, revenues are recognized when they satisfy two requirements:

- **Measurable** (quantifiable in monetary terms)
- **Available to Spend** (collectible in the current period or within 60 days of yearend)
  - Uses the **Financial Resources approach,** which measures only the current financial resources available to the Government.
  - The requirement that taxes be available to spend in the current period does not mean the taxes must be collected during the current period. When goods and services are received by the government, it will issue a voucher for payment, but is allowed up to 60 days to pay the voucher. Thus, revenue expected to be collected in the **first 60 days** of the **following** fiscal **year** may be considered **available to spend** in the **current year**.

Revenues and inflows of resources include both exchange and nonexchange transactions:

- **Exchange transactions** – Goods/services/cash of *equal value* are exchanged (GAAP).
  - Purchase electricity, water from enterprise fund.
- **Nonexchange transactions (4 types)** – A transaction in which the government gives/receives without directly receiving/giving equal value in exchange.
  - **"Derived" tax revenues** – Taxes that are self-assessed on exchange transactions (eg, sales tax, income tax, motor fuel tax).
    - The right of the government to receive the taxes arises when the underlying events (income, sales) take place, so revenues are accrued based on the time period of the income or sales that are being taxed.
    - Amounts *collected in advance* of the period to which they apply, such as overpayments of taxes in one period that are being applied to the next, are reported as *deferred revenue.*
  - **"Imposed" nonexchange transactions** – Taxes and fees assessed on assets or rights rather than exchange transactions (eg, property taxes, fines, forfeits, special assessments, licenses, permits).
    - A revenue when use of money is permitted and an asset when entity has a legal claim.

    - With respect to **licenses** and **permits**, the payment is optional, since the citizen may decide not to obtain the license or permit; thus, such amounts cannot be considered available to spend until the citizen pays the bill, so these are **not accrued** in advance.
    - **Property taxes** that have been billed are usually measurable and available and are thus **accrued** in advance of collection. A receivable is recorded, but the amount to be included in revenue is not the same as the amount levied, however. An allowance for uncollectibles must be established. Amounts that are not expected to be collected soon enough to be available to spend in the current period must be deferred.
  - **"Government-mandated" nonexchange transactions** – One level of government provides funds to another level of government to be used for a specific purpose (eg, federal grant).
    - Revenue when the eligibility requirements are met.
  - **"Voluntary" nonexchange transactions** – Transactions entered willingly by parties (eg, unrestricted grants, voluntary donations).
    - Revenue when the eligibility requirements are met.

For example, assume a calendar-year government levies $2,200 in *property taxes* on 11/1/X1. It expects to collect as follows:

November 20X1	400
December 20X1	900
January 20X2	300
February 20X2	250
March 20X2	225
Estimated uncollectibles	125

The entry to record the **billing** is as follows:

9/1/X1	Property Taxes receivable - current	2,200	
	Revenues		**1,850**
	Deferred revenues		225
	Allowance for uncollectibles		125

The amounts expected during 20X1 and the first two months (approximately 60 days) of 20X2 are considered available to spend in 20X1.

The deferred revenues are **reclassified** at the beginning of 20X2 when they represent the current year:

1/1/X2	Deferred revenues	225	
	Revenues		225

Collections of cash are applied to receivables or reported as revenues, depending on whether or not they were previously accrued. For example, if $2,000 of previously accrued property taxes is collected, the entry is:

Cash	2,000	
Property taxes receivable - current		2,000

If licenses and permits of $500 are **received,** the entry is:

Cash	500	
Revenues		500

Uncollectible accounts could either be written off or reclassified from current to delinquent. If they are **written off**, the accounting is done in the same manner as private businesses, reducing the allowance and the related receivables. If $100 of uncollected property taxes is written off, the entry is:

Allowance for uncollectibles	100	
Property Taxes receivable - current		100

Once the due date for a tax bill has passed, any remaining receivables and allowance accounts may be identified as **delinquent accounts.**

Property Taxes receivable - delinquent	100	
Property Taxes receivable - current		100

Allowance for uncollectibles	100	
Allowance for uncollectibles - delinquent		100

Of course, the allowance account may be adjusted, based on an aging of the remaining receivables. Just as the original entry to the allowance account reduced the net revenues recorded, adjustments are made to the revenues account. For example, if the allowance is reduced by $25 based on an aging, the entry is:

Allowance for uncollectibles	25	
Revenues		25

So far, the only receivable we have discussed is for property taxes. Because of the restriction that revenues must be both measurable and available, the only common source other than property taxes that might be accrued is a **grant** from another government unit.

For example, if our client is a local government, and the state government authorizes a $900 **unrestricted grant** that will be paid to the local government later in the current year, the entry at the time the grant is *approved* is:

Receivable from state grant	900	
Revenues		900

The *collection* of the grant is straightforward:

Cash	900	
Receivable from state grant		900

If the state grant is **restricted**, then it is not considered available until the local government has acted in accordance with the restriction. For example, if the $900 state grant is paid to the local entity immediately, but stipulates that the money must be spent on the purchase of new equipment, the receipt of the money (assuming no prior accrual occurred) is recorded as follows:

Cash	900	
Deferred revenues		900

When $600 of the money is *spent* on appropriate equipment, an expenditure of $600 is reported and a simultaneous entry is made to show that this portion of the grant is now available:

Deferred revenues	600	
Revenues		600

If the remainder of the grant money is not spent, it may have to be returned to the state government:

Deferred revenues	300	
Cash		300

The proceeds from the issuance of Long-term debt is recorded in the governmental fund as an "other financing source," not as a revenue.

Cash	1,000	
Other Financing Source		1,000

Expenditures

Under modified accrual accounting, costs are reported in accordance with the expenditure principle, which means that the focus is on the outflow of financial resources to pay for the good or service rather than on the benefits resulting from the cost. Thus, there is no parallel to the matching principle, and no attempt to amortize costs that benefit multiple periods.

Because of the importance of adhering to budgets in the governmental process, the initial entry in connection with the acquisition of an asset or service is made when the **order is placed** with the vendor. An open order is known as an **encumbrance** and can be considered a form of estimated expenditure. Unlike an appropriation, however, this represents an actual legal commitment, and requires that a portion of the fund balance be reserved.

For example, if an **order to purchase supplies is placed**, and the governmental entity estimates that the invoice for the supplies will be $900 when received, the following entry is made:

Encumbrances	900	
Reserved for Encumbrances		900

When an **order has been filled**, two entries need to be made. The first is to cancel the encumbrance, since it is no longer an open order. This just involves reversing the entry made when the order was placed:

Reserved for Encumbrances	900	
Encumbrances		900

The actual invoice from the vendor is also recorded. Keep in mind that it might not be for the exact same amount as was estimated in the encumbrance. If the supplies ordered earlier are billed to the government department for $890, the entry to record the approval for payment is:

Expenditures	890	
Vouchers payable		890

The actual **payment** of the voucher later is recorded as follows:

Vouchers payable	890	
Cash		890

Notice that the purchase of the supplies is recorded as an expenditure, even though the supplies may not have been used yet. This is known as the **purchases** method. It contrasts with the approach used by private businesses to record supplies as expenses only once they are used, known as the **consumption** method.

To avoid exceeding budgetary limits placed on the department, the sum of the expenditures recorded to date and the open encumbrances should not exceed the appropriations. For example, if appropriations for supplies were recorded in the initial budgetary entry for $1,500, and

expenditures to date are $890, open encumbrances for additional orders should not exceed $610. If it appears the budget for the year will be exceeded, the department should usually request a supplementary appropriation or other modification to the legislative budget.

Keep in mind that purchases of fixed assets are recorded as expenditures at the time of delivery of the assets to the government. Also note that the government may bypass the recording of encumbrances for repetitive expenditures, such as **salaries and wages** of employees. Note: At the end of any reporting period, the remaining balance of funds that are available for use for a city would be = Appropriations – Encumbrances – Expenditures = funds available.

Expenditures may be *categorized* in detail in several different ways:

- **Function or Program** – The category identifies the purpose or objectives of the expenditure. Examples are highways and streets, health and welfare, education, general government, **public safety**, disaster relief, and defense. Program includes drug addiction, education, and elderly. (**WHY - Purpose**)
- **Organizational Unit (department)** – This category groups expenditures based on the government's organizational structure. Examples include **police and fire departments**, city clerk, personnel department, parks, and recreational departments. These can be combined to form a Function category, such as public safety.
- **Activity** – This category classifies expenditures by activity which allows the ability to measure economy and efficiency of operations (eg, **police protection**).
- **Character** – The category identifies the fiscal period that the benefits are expected. Examples are *debt service-past* (matured interest and principal), *current services-present* (salaries and supplies), and *capital outlay-future* (police car and construction expenditures) (**WHEN**).
- **Object** – This category identifies the types of items purchased or services obtained. Examples are personnel services, salaries, rent, utilities, depreciation, and supplies. **(WHAT - Type)**
  - The statement of Revenues, Expenditures and changes in Fund balance generally reports expenditures by function within character classifications. Budgets often report expenditures by object class.
  - Function must be presented in either statement or footnotes.

Closing Entries

At the end of the fiscal year, several closing entries are required under modified accrual accounting. One is to close the entry that was made at the beginning of the year to record the budget.

For example, if the legislative budget included expected revenues of $700, bond proceeds of $200, expenditures of $500, and operating transfers to assist other departments of $250, the journal entry made at the **beginning of the fiscal year** would have been:

Estimated revenues	700	
Estimated other financial sources	200	
Budgetary fund balance – unreserved		150
Appropriations		500
Estimated other financial uses		250

At the **end of the year**, the closing entry is:

Budgetary fund balance – unreserved	150	
Appropriations	500	
Estimated other financial uses	250	
Estimated revenues		700
Estimated other financial sources		200

This is simply a reversal of the opening entry and is unaffected by the actual revenues and costs during the year.

The **second closing entry** that is needed is comparable to private businesses, and involves the *nominal accounts* created during the year for inflows and outflows related to revenues, other financing sources, expenditures, and other financing uses.

For example, if revenues recorded during the year totaled $710, other financial sources $190, expenditures $490, and other financial uses $230, the **closing entry at the end of the year** is:

Revenues	710	
Other financial sources	190	
Fund balance – unreserved		180
Expenditures		490
Encumbrances (for outstanding purchase orders)		X
Other financial uses		230

Notice that the excess of inflows over outflows of $180 is closed into fund balance – unreserved, which is the modified accrual accounting equivalent to retained earnings (or retained earnings – unappropriated) of a private business.

A third closing entry is needed for **open encumbrances**, that is, orders that were placed during the year but not fulfilled as of the end of the year. Since an encumbrance represents a legal commitment to purchase, it reduces the unreserved fund balance.

For example, assume that, during the year, orders totaling $500 were placed, and $470 of those were fulfilled, with the remaining $30 still open at year-end. As a result, there is a debit balance of $30 in Encumbrances and a credit balance of $30 in Reserved for encumbrances prior to the closing entries. The closing entry needed at year-end is:

Fund Balance – unreserved	30	
Encumbrances		30

The unreserved fund balance is reduced because of the commitment, and a separate fund balance – Reserved for Encumbrances now identifies the outstanding orders on the balance sheet. This can also be accomplished in the previous closing entry as the X above.

The fourth closing entry is needed if the government department elects to **keep track of its inventory** in the General fund. The purchase of inventory is usually recorded as an immediate expenditure (**Purchase method**).

If the **Consumption method** is used, Inventory would be debited as goods are purchased. This is used in government-wide statements. It is useful, however, for the legislative body to be aware of any remaining inventories at yearend, since this may affect the budget for purchases in later years.

For example, assume that the department purchased $300 of supplies during their first year of operations, but didn't use all of them, having an inventory of $80 at the close of the fiscal year.

To account for the outstanding inventory without affecting the unreserved fund balance, the following entry is made:

Inventory of supplies	80	
Reserved for inventories		80

In subsequent years, the inventory and related reserve account are adjusted up or down to account for changes in the inventory level. So, if the inventory of supplies at the end of the **second** year of operations is only $50, the closing entry to account for the decrease from the previous year is:

Reserved for inventories	30	
Inventory of supplies		30

It may be useful to summarize the net effect on fund balances of the various closing entries. Let's repeat all the closing entries discussed in this section (keeping in mind that the numbers used were arbitrarily selected). The starred items representing accounts whose entire balance is being eliminated as a result of the entry.

The closing of the **budgetary accounts:**

Budgetary fund balance – unreserved *	150	
Appropriations *	500	
Estimated other financial uses *	250	
Estimated revenues *		700
Estimated other financial sources *		200

The closing of the **nominal accounts:**

Revenues *	710	
Other financial sources *	190	
Fund balance – unreserved *		180
Expenditures *		490
Encumbrances (for outstanding po's)		X
Other financial uses *		230

The closing of the **encumbrance accounts**:

Fund Balance – unreserved	30	
Encumbrances*		30

The **adjustment to ending inventory**:

Inventory of supplies	80	
Reserved for inventories		80

If this represents the first year of operations for the specific government department, **the equity (fund balance) section** of the balance sheet will report the following amounts:

Fund balance – Unreserved	150
Fund balance – Reserved for encumbrances	30
Fund balance – Reserved for inventories	80